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SUBJECT: ISTANBUL ANALYSTS CONCERNED BY LACK OF IMF DEAL

¶1. (SBU) Summary: We participated in two May 2009 conferences in Istanbul: "Forum Istanbul" (the "Turkish Davos"), and the KPMG's "Financial Risk Management". High-level speakers included Central Bank Governor Durmus Yilmaz; Former Central Banker, now UNDP President, Kemal Dervis; Former IMF Vice President Ann Kruger; and Economist Dani Rodrik from Harvard University. Most participants and speakers agreed that Turkey may not need IMF financing for the short term but that it is likely to experience problems in the longer term unless it makes a deal with the IMF. They share the view that without a deal Turkey is likely to have external and domestic financing gaps in the medium term, and may be hit by economic contraction and unemployment, higher inflation, and a domestic financing gap in mid 2010. They noted the banking sector could be hard hit if the economic contraction continues. End Summary.

¶2. (SBU) Two prominent economists, Dervis and Rodrik, previously advocated for export-led growth strategies for Turkey but now acknowledge that countries hit most severely in this turmoil were those with strong export-led growth. Leading up to the collapse of Lehman Brothers in September 2008, Turkey's major concerns were a growing current account deficit of nearly 6.5 percent of GDP in 2008, and an increasing financing gap, then estimated at USD 45 billion. Corporate sector debt stock of USD 120 billion and increasing oil prices were also areas of concern.

¶3. (SBU) The picture changed dramatically with the onset of the global crisis. Demand for imports fell 43.4 percent year-on-year as of April 2009, and corporate sector external debt had an average 80 percent roll-over rate in the same period. Since October 2008, almost USD 18 billion flowed into Turkey through net errors and omissions, most likely a reflection of repatriation and spending of businessmen's money that had been held offshore. The fiscal picture also deteriorated as a budget that two years ago had a 6.5 percent primary surplus became a 1.5 percent primary deficit. Conference attendees speculated that unemployment may continue to increase from its record high 16.1 percent as of March 2009. Continued increases in global commodity prices may return Turkey's old friend inflation in the medium term, especially if the GOT fails to take necessary actions in policy and structural reforms in the short term.

¶4. (SBU) Murat Ulgen, HSBC Chief Economist, and Central Bank Vice Governor Erdem Basci noted the risk of increasing public debt stock will put pressure on the local government rates and threaten fiscal stability. Global Source's Murat Ucer said the marked rise in the domestic rollover ratio (at almost 120 percent compared to 85 percent in 2008), and the challenging domestic debt redemption schedule in August and October 2008 show the need for an IMF program. HSBC's Ulgen said an IMF arrangement is probably inevitable unless GOT authorities are willing to endure a painful adjustment.

¶5. (SBU) Conference participants also foresaw risks in the

bond market. Bonds remain subject to the twin risks of an end to the monetary easing cycle and fiscal deterioration, which could cause bond holders to demand higher premiums for assuming risk in Turkey. Cuneyt Sel, former Treasury Undersecretary, called attention to a decrease in privately held money in foreign currencies in offshore accounts. Sel, now a private consultant, told us that the loss of this "currency cushion" for business owners could lead to a sharp increase in the banks' NPLs (non-performing loans) which are currently low at 4.8 percent overall. Sel and Ucer both opined that the AKP does not have the technical expertise to manage the current crisis.

¶6. (SBU) Akil Ozcay, a former Central Bank Markets Director General, is now a senior advisor at the Turkish Economy Bank (TEB). Ozcay said that the GOT must make an IMF deal and take stringent measures to compensate for liberal spending prior to the March 2009 elections. Ozcay also expects NPLs to increase and said an interest rate differential could hit Turkey if the Central Bank continues to cut policy rates. Serdar Hamamcioglu, head of financial institutions in Citigroup, said securitization markets have stopped since September 2008 and bank balance sheets also stopped expanding due to decreases in deposits and loans. He confirmed that banks are increasing their cash positions as a safeguard measure. Hamamcioglu estimates that NPLs could increase to 7 percent for small- and medium-sized enterprises.

¶7. (SBU) Markets are now betting Turkey will make a deal with the IMF before the World Bank-IMF annual meetings (to be held in Istanbul on 6-7 October 2009). Over the past few weeks, it has become clear that the GOT is very reluctant to sign an

IMF program any time soon because it does not want to make tough fiscal adjustments. Cevdet Akcay, Chief Economist from Yapi Kredi-Koc, said in the absence of a deal, the primary balance of the overall public sector seems headed toward a deficit of 2 percent of GDP in 2009. Saruhan Ozel, Chief Economist from Denizbank, said Turkey needs to restore its credibility after two years of underperformance on the economic policy front and to secure the IMF funding to fill its financing gap. He sees further contraction in economic activity and currency depreciation as inevitable without an IMF deal.

¶8. (SBU) Comment: The bottom line of the conferences and private meetings is that without an IMF agreement the GOT has no intention to tighten fiscal policy. Even though investors have been generous to Turkey, this is not a sustainable trend if fiscal fundamentals are not carefully managed. If global sentiment turns negative, having a stand-by in place may help to minimize the negative effects on the economy. If the GOT fails to sign a stand-by or neglects to make any fiscal adjustment ahead of the 2011 elections, Turkey is unlikely to outperform other emerging markets or attract significant investment. End Comment.

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